

SAN FRANCISCO--( [BUSINESS WIRE](#) )--Fitch Ratings assigns an 'A' rating to the following Sacramento City Unified School District Joint Powers Financing Authority, California bonds:

--\$40.8 million lease revenue refunding bonds (LRBs), 2014 series A.

The bonds are scheduled to sell via negotiation on or about the week of Jan. 8, 2014.

In addition, Fitch affirms the following Sacramento City Unified School District (the district) ratings:

--\$213.7 million general obligation bonds (GOs) at 'A+';--\$32.6 million certificates of participation (COPs), series 2001 at 'A'.

The Rating Outlook is revised to Negative from Stable.

## SECURITY

The GOs are secured by an unlimited ad valorem property tax.

The LRBs and COPs are secured by annual lease payments for the use and occupancy of essential district school buildings.

## KEY RATING DRIVERS

**POOR FINANCIAL PERFORMANCE:** The Negative Outlook reflects the district's failure to return to structural budget balance in 2014 as previously predicted due to a failure to control spending. Financial oversight is weak.

**WEAK RESERVE POSITION:** The district's reserves are very weak with unrestricted general fund balance equal to just 3.2% of expenditures at the end of fiscal 2013. The district expects to spend reserves down to just 2% of expenditures in fiscal 2014.

**CHALLENGING BUDGET ENVIRONMENT:** The district must manage a volatile state funding environment and has no meaningful revenue raising flexibility because of state law, forcing budget adjustments to be made primarily through expenditure reductions.

**ECONOMIC RECOVERY BEGINS:** Sacramento's government-dominated economy has begun to recover from a deep recession with stabilization in the state of California's budget position. The region proved more vulnerable to cyclical downturns than expected in the recent recession, but has solid fundamental underpinnings.

**LARGE, DIVERSE TAX BASE:** The district's large, diverse tax base has begun to grow again after a period of relatively manageable assessed value (AV) declines.

**SIGNIFICANT LONG-TERM LIABILITIES:** The district's debt profile is weak, with a moderate but growing debt burden, manageable exposure to variable-rate debt, a poorly funded teachers' pension plan, and a large unfunded liability for other post-employment benefits (OPEB).

**MANAGEMENT WEAKNESS:** The district's management is in flux with the recent resignation of its superintendent. The governing board has shown a willingness to spend down reserves to an inadequate level.

## RATING SENSITIVITIES

**FAILURE TO RESOLVE STRUCTURAL IMBALANCE:** Fitch expects to downgrade the ratings if the district does not convincingly restore structural balance in the near term.

## CREDIT PROFILE

The district includes just over half of California's state capital and some adjacent suburban areas. The district is the state's 12th largest school system with 42,623 students.

## WEAK FINANCIAL PERFORMANCE

The district's financial position remains surprisingly weak in the face of a much improved revenue environment. The district has posted net deficits after transfers in three of the past four years and projects continued deficit spending in 2014 and 2015. Continued deficit spending would reduce reserves to the state's minimum 2% fund balance threshold for school districts of this size. The district had a deficit of \$1.7 million for the fiscal year ended June 30, 2013, reducing its unrestricted fund balance to \$12.4 million, or 3.2% of expenditures and transfers out.

The Negative Outlook largely reflects the district's failure to return to structural balance in 2014. Fitch downgraded the district's bonds in May 2013 on expectations that the district would spend reserves down to near the state minimum before restoring structural balance through budget cuts in fiscal 2014. In the spring of 2013, the district presented a list of board approved cuts that would have eliminated a \$5.2 million deficit for fiscal 2014, returning the district to structural budget balance. The district subsequently changed its spending plans, budgeting an 8% spending increase that more than fully offsets a 6.1% jump in funding due to an improved state revenue environment. The district now projects a deficit of \$10.2 million for the year.

## INADEQUATE RESERVES

Multiyear projections show fund balance decreasing to 2% of spending in the current budget year and not recovering meaningfully across the three year forecast horizon. The minimum reserve is inadequate to maintain the current ratings given the volatility in state funding the district routinely faces. The district is likely to beat the forecast slightly in the current year because of conservative elements of the budget; however, Fitch lacks confidence in the district's ability and willingness to control expenditures to the degree necessary to return to structural balance as forecast.

Financial oversight is weak. Policymakers have allowed the district to run persistent budget deficits, failed to make available spending adjustments that would have restored balanced budgets, and have drawn reserves to a level that leaves the district vulnerable to falling below the state's minimum fund balance requirement in the event of an economic shock or unanticipated expenditures. The district also lacks official board policies that would support a return to a higher level of reserves over time.

## IMPROVED REVENUE ENVIRONMENT

An improving state revenue environment should make it possible for the district to restore its financial health if policymakers choose to. The district is benefiting from the state's new Local Control Funding Formula (LCFF), which gives significant additional funding to schools with high numbers of second language learners and students in poverty or foster care. The district is likely to see continued improvement in state funding over the next several years, but revenue gains are unlikely to provide the robust surplus operations needed to rebuild reserves in the near term. The district's current multiyear projections assume gains in state LCFF revenue of 4.5% annually over the next two years. This assumption appears reasonable and could turn out to be conservative if state revenue improvements continue.

## SPENDING CONTROL IS KEY

The district has made very large cuts to spending in recent years by trimming staff, but it has failed to fully realign its expenditures to match its revenues in part due to a difficult to control increases in healthcare costs. General fund spending on employee benefits is projected to rise to \$110.5 million, or 26% of expenditures in the 2014 budget, from \$92 million, or 22% of expenditures in 2008. The district is also likely to face labor cost pressures from teachers who have not had a raise (outside of step and column raises) in

five years. The district's financial plans assume it can hold teacher salaries at their current level through 2015, but Fitch is concerned that any upside revenue performance would spur demands for raises that more than offset gains in revenues.

### STATE CAPITAL NOT INSULATED FROM ECONOMIC DOWNTURN

The district sits at the heart of a significant, government-dominated economy that has been hard hit by state budget cuts and the housing downturn. While the Sacramento region remains dominated by government - which provides more than a quarter of all jobs in the Sacramento metropolitan area - the economy has diversified over the years. The economy also includes significant healthcare, educational, professional services, technology, and construction industry employers. Sacramento's unemployment rates have not proven more stable than the state or the nation over recent business cycles, despite the presence of large governmental, healthcare and educational employers that would suggest greater economic stability. The city's non-seasonally adjusted unemployment rate was 9.8% in October 2013, down by more than two percentage points over the past year, but well above the national rate of 6.6%. District socioeconomic indicators are below average with an elevated poverty rate (19.6%) and median household income at 91% of the national level.

The school district's \$26.3 billion tax base is largely residential and quite diverse with the top 10 taxpayers representing just 3.8% of AV. Sacramento's older, more established housing stock has protected it from the extraordinary declines seen in communities with large amounts of new development during the housing boom. AV declined a manageable 9.4% from its peak in fiscal 2009 to its trough in fiscal 2013. AV returned to growth with a 3.6% gain in fiscal 2014. Broader economic and housing market improvement is likely to support continued tax base gains over the next several years.

### MODERATE BUT RISING DEBT BURDEN

The district's debt burden is moderate, with direct and overlapping debt equal to 4.1% of AV, or \$3,287 per capita. The district's debt burden is likely to rise somewhat over the next several years due to continued borrowing to support the district's capital plan. Sacramento voters approved a \$414 million GO bond authorization in November 2012, of which \$344 million remains to be issued over the next several years. The district is likely to issue the bonds gradually in a way that doesn't sharply increase debt ratios.

Amortization is solid with 48.6% of debt paid down over 10 years.

## TYPICAL LEASE PROVISIONS

The rated lease revenue bonds (series 2014A) are being sold alongside an unrated parity private placement (series 2014B) to refund the district's outstanding 2001 and 2011 COPs. The 2014B LRBs will refund variable-rate COPs currently outstanding as SIFMA index notes. The refunding will not meaningfully increase the general fund's debt service burden given the district's large budget and will improve the district's debt profile by replacing the SIFMA index notes (which were unhedged and needed to be rolled over periodically) with fixed-rate, fully amortizing lease revenue bonds.

The security is typical for California leases with a covenant to budget and appropriate, as well as a cash funded debt service reserve fund at the maximum size allowed by the Internal Revenue Service. The bonds are secured by lease payments from the district to the authority for essential assets - two of the district's seven high schools. The leases are subject to abatement if the district does not have beneficial use and occupancy of the properties. This risk is somewhat offset by the district's covenant to maintain the standard, 24-month rental interruption insurance policy.

## SIGNIFICANT RETIREE LIABILITIES

Post-employment liabilities are a significant and growing burden on the district. The district participates in California Public Employees' Retirement System (CalPERS) as well as in the poorly funded California State Teachers' Retirement System (CalSTRS) pension systems. Contribution rates for CalPERS are actuarially based, but those for CalSTRS are set by statute and have been below the level required to amortize the system's unfunded liability. The system reported a funded ratio of 69.3% for the fiscal year ended June 30, 2012. Fitch estimates the funded ratio to be 65.7% based on its more conservative 7% rate of return assumption. Fitch expects the district's CalSTRS contribution rate to rise over the coming years, perhaps significantly, after the legislature begins to address the system's growing unfunded liabilities. The district's unfunded accrued actuarial OPEB liability is particularly high at \$632.7 million, or 2.5% of AV.

Carrying costs for debt service, pension and OPEB were moderate at 16.5% of governmental funds spending in fiscal 2013. Rising healthcare costs and CalSTRS's weak funding ratio are likely to push carrying costs higher over the next several years, though district officials are actively working with labor unions to reduce the growth of medical and OPEB costs.

Additional information is available at [www.fitchratings.com](http://www.fitchratings.com).

In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria, this action was additionally informed by information from Creditscope, University Financial Associates, S&P/Case-Shiller Home Price Index, IHS Global Insight and the National Association of Realtors.

Applicable Criteria and Related Research:--'Tax-Supported Rating Criteria' (Aug. 14, 2012);--'U.S. Local Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

Applicable Criteria and Related Research:Tax-Supported Rating Criteria [http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=686015](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015)  
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